

ADDITIONAL COMMENTS OF BDO LLP IN RELATION TO PROFITABILITY

BDO understands that in practice:

1. partners joining an established professional services firm, including in particular the Big Four firms, inherit an established brand (which they do not pay for) and leave that behind when they retire (again for which they receive no value);
2. for most firms, a new partner's initial capital contribution is funded by back to back borrowing, sourced by the firm (i.e. it is borrowed by the partner from the firm's bank on preferential terms negotiated by the firm: such borrowings currently cost [3<] % for BDO, but BDO understands that each of the Big Four firms have negotiated slightly better terms for firm and partner bank borrowings), so the only "real" capital provided by the partner is provided via undrawn profits. This means that real gearing is quite high, while real capital is low;
3. most audit firms (including the Big Four) operate with a very low level of net assets, particularly if "off balance sheet" liabilities, such as liabilities to pay annuities to former partners, are taken into account;
4. in order to boost revenue, firms include disbursements charged through to their clients within their gross revenue figures, although these are passed through without margin. If profit margins are then considered in relation to the gross revenue figures, this will have the effect of reducing margin. However, because of redactions, it is not clear which figures have been used to calculate firms' margins. For the year ending 30 June 2012, PwC's expenses and disbursements on client assignments were £317m out of gross revenue of £2.6bn (12.2%), while Grant Thornton's client expenses and disbursements were £23.8m out of gross revenue of £417m (5.7%). For the 52 weeks ending 1 July 2011, BDO's were £8m from £273m (2.9%); and
5. as the CC has found, economies of scale in relation to audit firms are limited.

BDO considers that it is therefore very difficult to justify such a large premium for Big Four partners as some form of return on intangible assets.